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UNCLAS SECTION 01 OF 05 OTTAWA 000503

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E.O. 12958: N/A

TAGS: ECON EPET ETRD CA

SUBJECT: NATURAL GAS IN NORTH AMERICA:
CANADIAN PERSPECTIVE

REF: (A) 02 OTTAWA 2098 (GOC AGAINST ALASKA "SUBSIDIES")

- (B) 02 OTTAWA 1689 (ENERGY CONSULTATIVE MECHANISM)
- (C) 02 OTTAWA 2474 (ELECTRIC POWER OPPORTUNITIES)
- (D) 01 OTTAWA 2857 (NORTHWEST READY FOR GAS DEV'T)

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OUTSIDE USG CHANNELS.

SUMMARY/INTRODUCTION

¶1. (U) Although Canada's energy exports to the United States have grown at impressive rates in recent decades, making Canada our largest total energy supplier, Canada's conventional natural gas resources are maturing and production from current areas could peak within a decade. GOC forecasters expect that Canada's exports of natural gas will peak in 10-15 years and their share of U.S. demand will decline from about 18 percent at the peak, to perhaps 13 percent by 2025. Yet, like other countries, both the U.S. and Canada continue to build gas-burning infrastructure at high rates. There is a risk that future tight gas supplies and high prices could "strand" some of this investment (i.e. make it uneconomic before the end of its intended lifespan).

¶2. (SBU) Gas industry observers are increasingly focused on what is required in order for yet-to-be-developed northern gas resources - in Alaska and in Canada's northern territories - to take the place of these "maturing" conventional supplies. Because Canada is a net energy exporter, it is much more willing to accept high energy prices, and thus its economic interests with respect to northern gas development differ significantly from those of the U.S.

¶3. (SBU) An outcome attractive to key Canadian interests would likely entail (1) ensuring that two pipelines (Mackenzie Valley and Alaska Highway) are constructed, and (2) locating industrial benefits - perhaps a gas-liquids separation facility - in Canada. Observers argue that, while such a "big political deal" could be relatively straightforward and low-risk, only the USG has an overwhelming interest in brokering it.

¶4. (U) This message is based on conversations with contacts in Ottawa, Calgary and Edmonton and was prepared with assistance from Amconsul Calgary.

END SUMMARY/INTRODUCTION

GAS DEMAND GROWTH CONCENTRATED IN POWER SECTOR

¶5. (U) Recent rapid growth in overall demand for natural gas has been driven by this fuel's low cost and availability, and its low emissions relative to oil and coal. In electric power generation, another important factor is at work: gas-burning plants can be located very close to power markets, avoiding the need to construct additional power transmission lines, which has become very difficult politically (ref C).

¶6. (U) As a result, ExxonMobil forecasts that while total world energy demand will grow at an average 1.8 percent annual rate through 2020, gas demand will grow faster - 2.6 percent overall, and 3.6 percent in the power industry. By ExxonMobil's projection, gas will fuel 29 percent of the world's electricity by 2020 (versus 21

percent today).

CONVENTIONAL GAS SUPPLIES MATURING

¶17. (U) Most of Canada's natural gas production so far has come from the Western Canada Sedimentary Basin (WCSB) (ref B), where conventional production is expected to peak in 2008-2013. Symptoms of this maturation include simultaneous high drilling rates and declining new discoveries; steeply rising drilling/discovery costs; and a withdrawal from gas drilling activity by major energy firms.

¶18. (U) Coal-bed methane and other nonconventional gas sources, while they are promising, might not be large enough to fully offset the decline in conventional production. It appears unlikely that they will be sufficient to cause overall Canadian gas production to grow beyond the period 2015-2020 (see figure 5.6 of the National Energy Board study, "Canadian Energy Supply and Demand to 2025," at neb-one.gc.ca). As a result, the NEB expects Canada's natural gas exports to peak in the period 2013-2018. Canadian exports' share of total U.S. gas demand is projected to fall from 18 percent at the peak, to 13 percent by 2025.

THE NORTH IS WILD

¶19. (U) The "wild card" in this supply-demand projection is the development of gas resources from Alaska and northwestern Canada. Canada's northern territories (roughly north of 60 degrees latitude) contain significant oil and gas resources, notably gas in the Beaufort Sea and near the mouth of the Mackenzie River, a few hundred miles east of Alaska's Prudhoe Bay. National Energy Board (NEB) projections guesstimate that this gas will start coming to market in the period 2009-2017, and contribute modestly to supply - perhaps 1.5 to 2 billion cubic feet per day (Bcf/d) by 2025, on the order of one-tenth of Canada's total production. This GOC forecast limits itself to Canada, and is silent on Alaskan developments. Also, over longer time periods, development could extend to far larger reserves further north, in Canada's Arctic Islands.

¶10. (U) IN RECENT DECADES, THE OBSTACLES TO OIL AND GAS DEVELOPMENT IN THE TERRITORIES HAVE SHRUNK DUE TO A NUMBER OF TRENDS - INCLUDING TECHNOLOGICAL ADVANCES, INCREASED DEMAND FOR NATURAL GAS AS OPPOSED TO OIL (GAS BEING EASIER TO TRANSPORT IN COLD CONDITIONS), PROGRESS ON ABORIGINAL LAND CLAIMS SETTLEMENTS, AND GREATER RECEPTEIVENESS TO RESOURCE DEVELOPMENT AMONG ABORIGINAL GROUPS (SEE REF D FOR DETAILS). THE GOC HAS HELD REGULAR AUCTIONS OF EXPLORATION RIGHTS IN THE NORTHERN TERRITORIES SINCE THE LATE 1990'S (SEE WEBSITE INAC.GC.CA/OIL FOR DETAILS). NEVERTHELESS, GREAT UNCERTAINTY REMAINS ABOUT THE LENGTH OF THE POLITICAL-REGULATORY TIME LAG FROM PROPOSAL TO THE START OF CONSTRUCTION.

PIPELINE PLANS TO ACCELERATE THIS YEAR

¶11. (U) With rising energy prices in 2000-2001 and the release of the USG's National Energy Policy Report in May 2001, interest in northern pipeline developments revived. Various stakeholder groups formed alliances to promote one prospective route or another. The two most frequently suggested options are:

-- A relatively short, flat "all-Canadian" line from the Mackenzie Delta southward up the river valley and into northern Alberta. (In an ambitious, one-pipeline solution known as the "over the top" route, the north end of this line could conceivably extend westward to Prudhoe Bay - but this would greatly expand both the project's scale, and the political/environmental/aboriginal barriers to approval).

-- A more mountainous "Alaska Highway" line from Alaska's North Slope southward to Fairbanks, thence more or less along the highway route through the Yukon Territory and northern British Columbia to northern Alberta.

¶12. (U) The stakeholder alliance in support of the "all-Canadian" Mackenzie Valley line involves the Government of the Northwest Territories (NWT), the Aboriginal Pipeline Group (APG), and likely either or both of the largest pipeline operators -- TransCanada Pipelines (transcanada.com) and/or Enbridge (enbridge.com). Insiders expect the NEB to receive a formal application regarding this line during 2003. Supporters have lobbied the GOC for fiscal incentives, but so far without success, as the GOC (like the USG) remains officially

"route-neutral."

¶13. (U) Backers of the "Alaska Highway" line include the Governments of Alaska and the Yukon Territory, as well as Foothills Pipelines (foothillspipe.com). Foothills holds permits dating from the 1970's (and now of undefined value) to build a gas line on this route. Supporters and opponents are intensely interested in the final version of forthcoming U.S. energy legislation, since it may include various fiscal measures ("subsidies," pricing mechanisms, tax credits) which would affect the project's economics.

A MACKENZIE LINE ALONE WON'T BE ENOUGH

¶14. (U) While the "Canada-only" pipeline proposal may seem at this point to be moving toward realization, even if it were built first, it is not projected to offset either the decline in gas production from the WCSB, or the need to bring Alaska's North Slope gas to market. A "Canada-only" line would only deliver perhaps one-third as much gas as a line from Alaska. Moreover, Mackenzie gas is expected to be mostly or entirely consumed in Northern Alberta, since gas will be the main energy input to the production of crude oil from Alberta's oil sands. (This energy-intensive, heat-driven process will see immense capital investment over the coming decade as conventional oil production declines in Western Canada).

¶15. (SBU) If, as now seems quite possible, the "Canada-only" line begins construction first, this is considered unlikely to make much difference to the economic case for building a larger line from Alaska's North Slope soon afterward. On the other hand, if an Alaska line were to begin construction first, this could well put off the construction of a Mackenzie Valley line for at least several years. For one thing, the demand generated by the larger Alaska project would drive up prices for already scarce skilled labor, pipe, and other inputs; for another, the resulting gas supply would undercut the economic case for the smaller line.

ALASKA GAS: U.S. HOLDS THE BIGGEST INTEREST BY FAR

¶16. (U) Obviously, Alaska natural gas development must answer many questions and clear many hurdles in order to become reality. How much would it really cost to build? What are the environmental consequences? How can aboriginal groups best participate? Might liquefied natural gas (LNG) facilities make more sense as a transportation option?

¶17. (SBU) But those discussing these questions should be cognizant of Canadian factors which are too easily underestimated in a "lower 48" perspective:

-- If a pipeline (rather than LNG) is to be the means of transport, Alaskan gas must cross Canadian territory in order to reach major markets. That territory is at least 1,500 miles wide and is under four or more jurisdictions.

-- The usual close alignment of national economic interests will not necessarily hold in this case. Indeed, Canadian economic and regional interests could work against this development - at least, without some major political deal-making. And Canada, as an energy exporter, can tolerate the higher natural gas prices that might result if Alaskan gas remains undeveloped. Simply put, an Alaska gas pipeline is much more clearly in the U.S. national interest than it is in Canada's national interest. This is particularly true as a Canada-only Mackenzie Valley pipeline moves toward the proposal stage.

MAKING THE CASE TO CANADIANS

¶18. (SBU) Construction of a natural gas pipeline from Alaska would have positive economic spin-offs in western Canada, but Canadians in that region understand well that such effects are small and brief, because construction tends to employ "flown-in" skilled trades and lasts only a few seasons. The key sustained payoff for Canadian interests would be in hosting "gas stripping" facilities to separate liquids from the relatively "wet" Alaska gas. These liquids provide inputs for petrochemicals and plastics industries that are already established in Alberta, and which the provincial government is determined to expand in the long-term.

¶19. (SBU) On the downside, there are two major "negative risks" for Canadian interests. First, subsidies or other incentives granted to Alaskan gas could take market-distorting forms that would be inconsistent with both countries' expressed energy policies. Second, both construction and the resulting gas flows could undercut the economics of a Mackenzie Valley pipeline. Regional and some

national leaders very much want the latter pipeline for its wider regional development effects - including all-season roads and stimulus to hydrocarbon and mineral exploration (see ref D).

¶20. (SBU) It bears noting that these concerns could be easy for U.S. interests to address. Alberta (or northeasteren British Columbia) may well be the most economic location in North America for gas-liquids separation, given northern Alberta's already massive gas processing capacity. Market-distorting subsidies are, after all, not in either country's true interest. And as noted above (para. 15), the Mackenzie Valley line, which may have a head start anyhow, is not expected to change the fundamental economic case for Alaskan gas development.

COMMENT: THE BOTTOM LINE

¶21. (SBU) COMMENT: North America will need to have its "north of sixty" natural gas developed during the next two decades. We can discern features of a possible low-cost, low-risk political bargain that could pave the road to developing this gas - by assuring key jurisdictions that they will benefit, without imposing gross distortions on energy markets.

¶22. (SBU) The USG and GOC are already committed to "route-neutrality" and in most parties' opinions - as well as from an economic standpoint - they should remain so. If fiscal regimes must be tilted in favor of developments preferred by the State of Alaska, it is clearly in the broader U.S. national interest (economically and diplomatically) to minimize the bias.

¶23. (SBU) Most stakeholders will be satisfied if two pipelines - both the Mackenzie Valley (probably first) and the Alaska line -- eventually get constructed. This would satisfy top concerns of the sub-federal governments and other groups in both the Yukon and Northwest Territories. This outcome is also positive for northern Alberta oil-sand interests and for the Government of Canada - as well as for North America's continental energy security. Finally, a "politically ideal" compromise would deliver some industrial benefits to British Columbia as well as to Alaska and Alberta.

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